No. 14,694

In the United States Court of Appeals for the Ninth Circuit

ELLA E. HARROLD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The opinion of the Tax Court (R. 37–46) is officially reported at 22 T. C. 625.

JURISDICTION

This petition for review (R. 52–58) involves federal income taxes for the taxable years 1946, 1947 and 1948. On February 21, 1952, the Commissioner of Internal Revenue mailed to the taxpayer a notice of the deficiency in the total amount of $32,883.63. (R. 12–19.) Within ninety days thereafter, and on May 14, 1952, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal

Revenue Code of 1939. (R. 6–30.) The decision of the Tax Court sustaining the deficiency in the amount of $26,576.89 was entered on December 20, 1954. (R. 51.) The case is brought to this Court by a petition for review filed February 1, 1955. (R. 52–57.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Where taxpayer and her former husband filed separate return for the taxable years involved, whether the Tax Court was correct in holding that taxpayer is liable for payment of taxes on her share of community income, and the Commissioner could not be required to apply an overpayment by her former husband to taxpayer's deficiencies under Section 322 (a) (1) of the Internal Revenue Code of 1939.

STATUTES INVOLVED

Civil Code of California (Deering, 1949):

> SEC. 161a. [*Interests in community property.*] The respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing and equal interests under the management and control of the husband as is provided in sections 172 and 172a of the Civil Code. This section shall be construed as defining the respective interests and rights of husband and wife in the community property. [Added by Stats. 1927, p. 484.]
>
> SEC. 172. [*Management of community personal property: Limitations: Consent of wife.*]

The husband has the management and control of the community personal property, with like absolute power of disposition, other than testamentary, as he has of his separate estate; provided, however, that he cannot make a gift of such community personal property, or dispose of the same without a valuable consideration, or sell, convey, or encumber the furniture, furnishings, or fittings of the home, or the clothing or wearing apparel of the wife or minor children that is community, without the written consent of the wife. [Enacted 1872; Am. Stats. 1891, p. 425; Stats. 1901, p. 598; Stats. 1917, p. 829.]

SEC. 177. *Rights of husband and wife governed by what.* The property rights of husband and wife are governed by this chapter, unless there is a marriage settlement containing stipulations contrary thereto. [Enacted 1872.]

Internal Revenue Code of 1939:

SEC. 322. REFUNDS AND CREDITS. (a) [As amended by Sec. 172 (e) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Authorization.*—

(1) *Overpayment.*—Where there has been an overpayment of any tax imposed by this chapter, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer.

* * * * *

(26 U. S. C. 1952 ed., Sec. 322.)

STATEMENT

The relevant facts, most of which were stipulated by the parties (R. 33–36) and were found by the Tax Court (R. 38–40), may be summarized as follows:

Taxpayer and Ellsworth Harrold (hereinafter referred to as Harrold) were married in 1936, and thereafter resided in California as husband and wife. During 1945, certain differences arose between taxpayer and Harrold, and she commenced an action for separate maintenance. During the pendency of these proceedings, taxpayer and Harrold entered into a property-settlement agreement, dated June 30, 1945. However, on or about September 15, 1945, they became reconciled and again lived together as husband and wife in the State of California. (R. 38–39.)

Taxpayer and Harrold filed separate, individual, federal income tax returns for the calendar years 1946, 1947, and 1948. Harrold was the owner of two business enterprises. In 1946 he had them separately incorporated and the shares of stock issued to him. He reported the net income of these businesses, up to the time of incorporation, and the salary received thereafter from the corporations, as his separate income on his returns for 1946, 1947, and 1948. He paid taxes on the income so received, together with income received by him from various other sources. In her return filed for these years taxpayer did not report any of the income or salary from these two business enterprises. (R. 39.)

A second separation occurred during March, 1948, and a suit for divorce was instituted by taxpayer.

On February 15, 1949, an interlocutory decree of divorce was handed down by the Superior Court of the State of California, in and for the County of Sacramento. The Superior Court confirmed the property-settlement agreement, dated June 30, 1945, insofar as it effected transfers of property owned by taxpayer and Harrold at that time. (R. 39.)

The Superior Court further determined that the income attributable to the personal services of Harrold subsequent to September 15, 1945 (the date of the reconciliation), was community property. An adjudication was accordingly made by that court that a portion of the net income derived by Harrold from the two business enterprises prior to their incorporation, plus the entire salary received by him after the incorporation, constituted community property. (R. 39–40.)

In determining the residual amounts of the community property to be divided between taxpayer and Harrold, the Superior Court deducted from and charged the community property with various items, including living expenses and the amount of federal and state income taxes paid by Harrold. After such deductions were made the balance of the community property amounted to $1,734.24, and one-half, or $867.12, was awarded to taxpayer as her share of the residual community property. (R. 40.)

After the entry of the divorce decree, Harrold filed amended income tax returns for 1946, 1947 and 1948, in which he reported as income one-half of the portion of the business income which was attributable to his

personal services prior to incorporation, and one-half the salary he received after incorporation. He also filed claims for refund of a portion of the federal income taxes paid by him for these three years, based upon the theory that he had erroneously overstated his income for these years by including in his returns taxpayer's community share of the income from these two businesses. Pending the consideration of this refund claim, the Commissioner determined that one-half of the community income earned during 1946, 1947 and 1948 should be added to the income reported in taxpayer's returns for these years. (R. 40.)

The Tax Court held that taxpayer was liable for the payment of taxes on her share of community income and that the Commissioner could not be required to apply an overpayment by a former husband to taxpayer's deficiencies. (R. 37–46.)

Subsequent to Harrold's filing a claim for refund, but prior to the issuance of the Tax Court's opinion, taxpayer commenced an action against Harrold in the Superior Court of the State of California, in and for the County of Sacramento, to have that court either redetermine the amount of residue of the community property to be awarded to her, or issue a declaratory judgment that when Harrold collected any refunds she would be entitled to receive part thereof. Taxpayer's complaint was dismissed by the Superior Court; the judgment of dismissal was affirmed by the District Court of Appeals of California; and a petition for hearing by the Superior Court of California was denied by that court. (R. 54–55.)

SUMMARY OF ARGUMENT

1. Under Section 161a of the Civil Code of California, a wife's interests in community property during the continuance of the marriage relation are present, existing and equal. It is also clear that where a husband has invested his capital in a business which he operates, remuneration received by him for his services to the business, as contrasted with profits derived therefrom, constitute community income. Thus, in accordance with the doctrine enunciated by the Supreme Court in *Poe* v. *Seaborn,* 282 U. S. 101, *United States* v. *Malcolm,* 282 U. S. 792, and related cases, where, as here, a husband and wife file separate returns, each is separately liable for the tax on one-half of the community income. Further, the state court, in a suit between the taxpayer and her former husband, has held that the very income involved here was community income.

2. The Commissioner cannot be required to apply toward taxpayer's deficiencies overpayments made by her former husband, since divorced, toward his taxes as shown on his separate return. A set-off of an overpayment against a deficiency can be made only where the same taxpayer is involved, unless both the taxpayer to whom the refund may be owing and the Commissioner agree that the overpayment may be applied to the deficiency of another.

In any event, it is clear that no such set-off should be made here. The rights of the taxpayer and her former husband in community property at the time of their divorce were settled by the divorce court, whose

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decree was permitted to become final, after which taxpayer's petition in the state court, attempting to raise the question she is attempting to raise here, was denied upon the ground that the original divorce decree settling the question had become final, and the matter was *res judicata.* Its ruling is not only binding between the taxpayer and her former husband, but was correct. In the litigation in the state courts it was decided that the income from the former husband's services, the income involved here, was community property, hence at the time the decision was rendered taxpayer knew she had underpaid her taxes because she had reported none of this community income for the years involved, and it was equally apparent that her former husband had erroneously included the full amount thereof in his returns and hence would be entitled to a refund. As the taxpayer did not raise the question in the state court, though she could have done so timely, the question has become *res judicata* as between her and her former husband. *Tait* v. *Western Md. Ry. Co.,* 289 U. S. 620.

Regardless of whether the divorce decree is *res judicata* as between the taxpayer and her former husband, she is not entitled to the claimed set-off. The Tax Court correctly found that there was no evidence that the overpayment by her former husband was made out of community property. But even if community property were the source of her former husband's payments, taxpayer would not be entitled to have his overpayment applied to her taxes.

ARGUMENT

The Tax Court correctly held that taxpayer is liable for the payment of taxes on part of the community income received by her then husband from businesses operated by him, and that the Commissioner is not required to apply an overpayment by her former husband to deficiencies in taxpayer's separate returns for 1946, 1947, and 1948

A. Introduction

During 1946, 1947 and 1948, taxpayer and Harrold lived together as husband and wife, but filed separate tax returns. Harrold was the owner of two businesses from which he received $96,258.86 in income in 1946. The Commissioner allocated 53.5 per cent of this income to a ten per cent return on Harrold's investment in the businesses and excluded this amount from the community income. The balance of the income, or $44,760.37, was considered to be salary received by Harrold from the businesses, and was held by the Commissioner to constitute community income. Half of this community income, or $22,380.18, was considered to be income to taxpayer. (R. 14.) In 1947 and 1948, the businesses were incorporated, and the Commissioner allocated to taxpayer's income half of the salaries received in those years in return for Harrold's personal services to the companies, or $14,005 for 1947, and $18,420 for 1948. (R. 17, 19.)

Taxpayer does not question the validity of these allocations, but contends instead (Br. 10–16) that she is not liable for any tax on her share of the community property, or, alternatively (Br. 16–43), that her tax liabilities should be set off against any refund which her former husband, Harrold, might obtain. We submit that neither of these contentions is valid.

B. Taxpayer is liable for the tax on part of the income received from the businesses

Section 161a of the Civil Code of California (Deering, 1949), *supra,* was amended in 1927 to provide that a wife's interests in community property during the continuance of the marriage relation are present, existing and equal. Since the 1927 amendment the community income of spouses residing in California is equally divisible, and where they file separate returns each spouse is permitted and required to return one-half thereof. *United States* v. *Malcolm,* 282 U. S. 792; *United States* v. *Merrill,* 107 F. Supp. 836 (S. D. Cal.)

The Supreme Court of California in *Harrold* v. *Harrold,* 43 Cal. 2d 77, 271 P. 2d 489, 491,[1] held that where the husband here invested his capital in a business which he operated, remuneration received by him for his services to the business, in contrast to the profits derived from the business, constituted community property. This is fully in accord with the other decisions of the state courts of California and of this Court. *Shea* v. *Commissioner,* 81 F. 2d 937 (C. A. 9th); *Devlin* v. *Commissioner,* 82 F. 2d 731 (C. A. 9th); *Pedder* v. *Commissioner,* 60 F. 2d 866 (C. A. 9th); *Pereira* v. *Pereira,* 156 Cal. 1, 7, 103 Pac. 488, 491; *Estate of Gold,* 170 Cal. 621, 151 Pac. 12; *Estate of Caswell,* 105 Cal. App. 475, 481, 288 Pac. 102, 104; *Witaschek* v. *Witaschek,* 56 Cal. App. 2d 277, 281–282,

[1] See also the decisions of the District Court of Appeals in this case which further determined taxpayer's share of the community property and earnings: 100 Cal. App. 2d 601, 224 P. 2d 66; 117 Cal. App. 2d 664, 256 P. 2d 626; 261 P. 2d 800; and 127 Cal. App. 2d 582, 274 P. 2d 183.

132 P. 2d 600, 603; *Logan* v. *Forster,* 114 Cal. App. 2d 587, 599–600, 250 P. 2d 730, 737. Cf. *Boland* v. *Commissioner,* 118 F. 2d 622 (C. A. 9th); *Todd* v. *Commissioner,* 153 F. 2d 553 (C. A. 9th), remanding 3 T. C. 643, rehearing denied, 153 F. 2d 558, original findings affirmed on remand, 7 T. C. 399, affirmed 165 F. 2d 781.

Hence, the Tax Court was clearly correct when it held that since taxpayer and her husband filed separate returns each spouse was separately liable for the tax on one-half of the community income.[2] *Poe* v. *Seaborn,* 282 U. S. 101; *United States* v. *Malcolm, supra, Boland* v. *Commissioner, supra; Sherman* v. *Commissioner,* 76 F. 2d 810 (C. A. 9th); *Hunt* v. *Commissioner,* 22 T. C. 228; *Sutor* v. *Commissioner,* 17 T. C. 64; *Dunn* v. *Commissioner,* 3 T. C. 319. See, *Stewart* v. *Commissioner,* 95 F. 2d 821 (C. A. 5th). See also, *Hunt* v. *Commissioner, supra,* where the Tax Court stated (p. 230):

> For purposes of Federal income taxation, each spouse is equally liable for payment of the tax on his or her respective equal share of the community income. *United States* v. *Malcolm,* 282 U. S. 792 (1931); *Poe* v. *Seaborn,* 282 U. S. 101 (1930). This liability is fixed and definite. It is not a means of splitting income which may be voluntarily chosen or elected to

[2] The fact that taxpayer and Harrold entered into a separation agreement in 1945 is of no consequence, since the parties to this agreement subsequently became reconciled, and during the years involved herein, they lived together as husband and wife. Consequently, amounts earned by Harrold during the period of reconciliation would constitute community income. *Mundt* v. *Connecticut Gen. Life Ins. Co.*, 35 Cal. App. 2d 416, 95 P. 2d 966; *Toomey* v. *Toomey*, 13 Cal. 2d 317, 89 P. 2d 634.

minimize taxes. The wife may not, at her option, return one-half of the community income; she must do so. See *Paul Cavanagh,* 42 B. T. A. 1037 (1940), affirmed on another issue 125 F. 2d 366 (C. A. 9, 1942). Her liability for tax ceases only when her interest in the community income ceases. The time when that interest comes to an end is determined by California law. *Poe* v. *Seaborn, supra.*

C. The Commissioner cannot be required to apply an overpayment by taxpayer's former husband in his separate returns to taxpayer's deficiencies in her separate returns for the same years

Section 322 (a) of the Internal Revenue Code of 1939, *supra,* provides that where there has been an overpayment of a tax, the amount of such overpayment shall be credited against any tax then due from the taxpayer, and any balance shall be refunded to the taxpayer. This right of set-off has been strictly limited by numerous decisions which hold that a set-off of an overpayment and a deficiency can be made only where the same taxpayer is involved, unless both the taxpayer to whom the refund may be owing and the Commissioner agree that the overpayment may be applied to the deficiency of another taxpayer. *Edmonds* v. *Commissioner,* 90 F. 2d 14 (C. A. 9th); *Claire* v. *United States,* 34 F. Supp. 1009 (C. Cls.); *Krug* v. *United States,* 18 F. Supp. 242 (C. Cls.); *Gruy* v. *Commissioner,* 42 B. T. A. 1279, 1287; *Perine* v. *Commissioner,* 22 B. T. A. 201; *Vayssie* v. *Commissioner,* 8 B. T. A. 587. Cf. *Huntington Nat. Bank* v. *Commissioner,* 90 F. 2d 876, 879–880 (C. A. 6th); *Wynne* v. *Commissioner,* 77 F. 2d 473 (C. A. 5th); *Meyers* v. *Commissioner,* 21 T. C. 331, 347; *Green* v.

Commissioner, 7 T. C. 263, 277–278; *Masterson* v. *Commissioner,* 1 T. C. 315, 328.

Nevertheless, taxpayer contends (Br. 10–12), that her former husband, as well as the community property itself, is personally liable for the taxes shown on both returns since he was manager of the community property. We submit that the answer to this question is immaterial to the issue presented here. Whatever may be the liability of the husband as long as the community exists, this does not affect the former husband's rights to his overpayment involved here. In the instant case the rights of the taxpayer and her former husband in the community property at the time of their divorce were settled by the divorce court, whose decree was permitted to become final before taxpayer attempted to raise the question which she seeks to raise here. At the time that decision was rendered taxpayer knew that she had underpaid her taxes for the years involved here because she had reported no community income for those years. It also seems clear that at that time it was apparent that the former husband had included the full amount of the community income in his returns, and therefore was entitled to a refund. Hence, taxpayer could have and should have raised the question timely in the state court which she presently attempts to raise here. As she failed to do so, the question has become *res judicata*. *Tait* v. *Western Md. Ry. Co.,* 289 U. S. 620. Indeed, the taxpayer untimely attempted to reopen the divorce decree in order to raise substantially the same question which she attempts to raise here,

and the state court held that the matter was *res judicata* between her and her former husband.

While the cases cited by taxpayer on the set-off question are not applicable because the rights between taxpayer and her former husband here have been determined in the state court divorce proceedings, we submit that they can be distinguished. For example, the decision in *Clayton* v. *United States,* 44 F. 2d 427 (C. Cls.), was predicated upon the ground that where the spouses had filed joint returns the Commissioner could credit the overpayment by one of the spouses to the account of the other. Likewise in *Lattimore* v. *United States,* 12 F. Supp. 895 (C. Cls.), a joint return was filed.

Nor is *Marshall* v. *United States,* 26 F. Supp. 474 (C. Cls.), applicable herein. In that case the wife had consented that her tax payment could be applied to the husband's tax. She later withdrew her consent.

The majority of the Court of Claims believed that the case should be decided upon the ground that the wife was not entitled to a refund since the Commissioner correctly had cancelled the overassessment in her favor, and that she had not overpaid her tax. The majority disagreed with Judge Littleton's concurring opinion. This disagreement is clearly demonstrated by the decision of *Claire* v. *United States, supra,* where the Court of Claims held that where the spouses had filed separate returns, and one spouse overpaid his tax, there could not be any set-off between a husband and wife's accounts in the absence of an agreement, *although both returns included com-*

munity income. See also, *Edmonds* v. *Commissioner, supra.*

Both *Matter of Ryan* (S. D. Cal.), decided December 13, 1949 (1951 C. C. H., par. 9493), and *Matter of Rogers* (S. D. Cal.), decided October 18, 1951 (1951 C. C. H., par. 9495), relied upon by taxpayer (Br. 10–12), are distinguishable. In *Matter of Ryan* the District Court found:

> All of the income reported in their separate returns by Mr. and Mrs. Ryan for the year 1945 was post-1927 type California community income of the spouses, and was derived partly from the husband's services and in part from assets of the same community type directly traceable to his services. No partnership between the spouses existed. All of the assets of the bankrupt estate are of the same community type. The claims of the general creditors herein were contracted by Mr. Ryan for, on behalf of, and in connection with, the community enterprise; and the community assets of the estate are insufficient to pay such creditors in full.
>
> *   *   *   *   *
>
> The Court further finds that no Federal income tax returns for the year 1945 were filed by the spouses until after the commencement of these bankruptcy proceedings, and neither spouse paid any part of the Federal taxes upon the income received in said year.

The court then held "that 100% of the community property is liable for the taxes upon said half of the 1945 income reported in Mrs. Ryan's return and

assessed in her name." In *Matter of Rogers* the referee found:

> III. That all the income reported by George J. and Rose Rogers in their separate returns for the years 1947 [and 1948] was post 1927-type California community income of the spouses and was derived partially from the husband's services and in part from the assets of the same type of community property.
>
> IV. All the assets of this estate are of the same type of community property.

The referee also found that the spouses filed a joint return for 1948. The referee then held "that all of the community property of the spouses is liable for the taxes reported by Rose Rogers in her separate return for the year 1947 and assessed in her name," and that the bankrupt estate is indebted for the taxes of both spouses for 1947 and 1948. Thus, it is clear that both of these cases involved the right to collect the taxes of spouses, who were at the time spouses, out of the community property of both, which is a far different situation from that of the present case.

Preston v. *Commissioner,* 21 B. T. A. 840, is not applicable to the facts of the present case. In *Preston* the wife did not have any separate income, and the *husband* actually paid both his and his wife's taxes out of the community income. There had been no divorce and settlement of rights in the community property. That case held nothing more than that under its facts (p. 849) "the husband should be allowed credit for the total amount of tax paid on the community income return by both spouses, to the ex-

tent that such payment has not been refunded or otherwise credited." If the case holds anything more than this, that a husband and wife who file separate returns should be allowed a set-off of their separate tax liabilities, the decision is wrong.

The decision of *Stone* v. *White,* 301 U. S. 532, relied upon by taxpayer (Br. 27–29), is not applicable here. In the first place numerous decisions have made it clear that the Tax Court does not have any equity jurisdiction. *Commissioner* v. *Gooch Co.,* 320 U. S. 418. See *Rothensies* v. *Electric Battery Co.,* 329 U. S. 296, 303; *Mohawk Petroleum Co.* v. *Commissioner,* 148 F. 2d 957, 959 (C. A. 9th); *Babcock & Wilcox Co.* v. *Pedrick,* 212 F. 2d 645, 649 (C. A. 2d); *Hutchings-Sealy Nat. Bank* v. *Commissioner,* 141 F. 2d 422 (C. A. 5th); *Lincoln Electric Co.* v. *Commissioner,* 162 F. 2d 379 (C. A. 6th); *Fisher* v. *Commissioner,* 149 F. 2d 540 (C. A. 7th); *Gillespie Trust* v. *Commissioner,* 21 T. C. 739, 742. Secondly, the facts of the *Stone* case differ from those of the present case. There the tax was paid by the trustees, although the tax should have been paid by the beneficiaries. The Supreme Court permitted a set-off on the ground that any refund to the trustees would have inured to the beneficiary and would have enabled her to escape a tax she should have paid.

Since the Tax Court does not have equity jurisdiction, and it is impossible to obtain jurisdiction over the former husband in this proceeding, its decision would not be binding upon the former husband, especially in view of the state court's rulings. Similarly,

if the Commissioner refused to turn over the overpayment to the former husband, the wife could not be made a party to his action for refund. Hence, the Government in neither case could be protected. Clearly, the rights of the taxpayer, if any, in the former husband's overpayment cannot be decided here, but was properly decidable and decided in the prolific litigation between taxpayer and her former husband in the state court forum.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed by this Court.

Respectfully submitted.

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